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ROLE OF TRANSNATIONAL CORPORATIONS IN THE NEWLY OPENED ECONOMIES OF CENTRAL AND EASTERN EUROPE

Foreign direct investment in the newly opened economies of Central and Eastern Europe

Report of the Secretary-General

SUMMARY

Foreign direct investment (FDI) in the newly opened economies of Central and Eastern Europe (CEE), at its present level, remains a relatively recent phenomenon. The situation is rapidly changing, and all of the CEE economies are in the process of opening up and introducing domestic competition, which will render a great share of the economies' capital stock obsolete.

The potential role of FDI, economic policies adopted by Governments and the rebuilding of the capital stock of CEE economies will be decisive in their transformation to market economies. In the long term, the role of FDI in this process will be important. Together with commercial lending and official flows, FDI can be expected to make significant contributions to management and skill training, improving technology transfer, expanding export markets and developing new sectors of the economy.

While many CEE Governments have made considerable progress in the design and implementation of legal and regulatory frameworks to provide a more enabling environment for FDI, there remains a need to enhance domestic policy coordination, abolish the remaining restrictions on FDI and strengthen management capacity for the efficient implementation of policies and other measures now governing FDI. Overall inflows of FDI and maximization of its benefits will greatly depend on Governments' ability to implement programmes of macroeconomic stabilization and transformation of the economy, as well as the maintenance of social stability.

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INTRODUCTION

1. At its substantive session of 1992, the Economic and Social Council in its decision 1992/282 approved the provisional agenda for the nineteenth session of the Commission on Transnational Corporations and included in it an item on the role of transnational corporations in newly opened economies, with a report of the Secretary-General on this subject as documentation. The present report has been prepared in response to that request.

2. The notion of newly opened economies includes countries undergoing adjustments towards market-oriented structures. The Transnational Corporations and Management Division has been closely monitoring these developments and has been presenting its findings in United Nations publications, including the World Investment Directory, 1992, 1/ a report on foreign direct investment in China (ST/CTC/73), a report of joint ventures as a form of international economic cooperation (ST/CTC/93) and reports related to the conduct of international symposiums in Moscow (1991) on governance and structural transformation in transitional economies (TCD/SEM.92/12), and in Beijing (1992) on linkages of microeconomic reforms and macroeconomic adjustment in transitional economies. 2/

3. The present report addresses the main issues associated with foreign direct investment (FDI) in the newly opened economies of Central and Eastern Europe (CEE) 3/ as a result of the dramatic systemic changes in CEE countries, including the countries of the former USSR, during their transition from centrally planned to market-oriented structures.

4. Since the far-reaching changes of the late 1980s and early 1990s, the CEE region as a whole has been undergoing rapid development. Problems in the transition of the region to market-oriented structures remain considerable. The present report, based on information contained in four United Nations publications, 2,/ 4/, 5/, 6/ focuses on the general rather than the country-specific dimensions of FDI in the CEE economies. There are, however, important variations regarding all aspects of FDI among the individual CEE economies. 7/

5. The report analyses FDI within the overall macroeconomic, policy and regulatory context in which it is currently evolving. It provides a preliminary analysis of the recent role and impact of FDI on the ongoing reform processes; the analysis is qualitative rather than quantitative as the database on FDI in CEE economies does not allow for a detailed quantitative assessment of the impact of FDI. Also, limited experience has so far been gained with both the impact of FDI and the relationship between evolving policy, legal and regulatory measures, on the one hand, and trends in flows of inward FDI on the other. The report also outlines policy and technical assistance measures likely to maximize the positive impacts of FDI on the restructuring and transformation processes.

I. FOREIGN DIRECT INVESTMENT: STRUCTURE AND TRENDS

A. The foreign investor's perspective in a changing economic environment

6. The CEE economies, following the events of the late 1980s and early 1990s, found themselves in a very precarious state, with falling output, soaring inflation, widespread shortages and, in some countries, high levels of external debt. 5/ To prevent further economic deterioration and prepare for institutional reform, stabilization plans were implemented. The economic programmes adopted in all countries focused on institutional reform and stabilization, although detailed provisions of economic policy varied from country to country. Considerable differences in initial macroeconomic conditions and varying experiences of market reforms throughout the 1980s influenced the design and timing of reforms in individual countries. As a result, the CEE economies remain at different stages of transformation.

7. All of the CEE countries are in the process of transforming their economies from central planning to market allocation. The emerging pattern of transformation and restructuring seems to lead to the formation of two clusters of Eastern European countries: a comparatively affluent northern group comprising Poland, the former Czechoslovakia and Hungary; and a southern group comprising Albania, Bulgaria and Romania. Within the former USSR, similar trends appear to be developing with the Central Asian republics lagging behind the European republics of the Commonwealth of Independent States.

8. While there are very few signs of economic recovery, industrial production in Poland, the former Czechoslovakia and Hungary stopped falling during the second half of 1992. The major economic indicators point to continued recession in Romania, Bulgaria, Albania and the former USSR. The growth of private business, especially small- and medium-sized retail companies (shops, restaurants and services), contributed considerably to the economic recovery in some countries. These companies are responsible for breaking the fall in Polish production, rapid growth in Hungary's trade with the European Community countries and falling unemployment in the former Czechoslovakia. 8/ However, levels of output in 1991 were no higher than 10 years ago and domestic capital investment fell to the levels of the middle 1970s. The last three years have witnessed such deep cuts in investment outlays that even essential maintenance has been delayed or neglected, threatening much of the viable capital stock. Industrial production has been especially hard hit. The collapse of trading relationships sponsored by the Council for Mutual Economic Assistance had a negative impact on production for exports. While the radical elimination of import barriers stimulated production in some countries, import restraints, induced by currency shortages, deprived industry of necessary raw materials, equipment and replacement parts. In the former USSR, this is especially the case in the food, pharmaceutical, textile, garment and footwear sectors.

9. The structural roots of the CEE economic crisis suggest that several CEE economies will continue to experience macroeconomic disequilibria for some time to come. Even assuming favourable external factors and domestic reforms, the time it will take to catch up with market economies and reach levels of income comparable to those of the industrial countries will certainly be measured in decades rather than years. Growth prospects in the CEE economies will depend

largely on their ability to attract FDI but equally on their ability to renew fiscal balance; control external payment and trade balances and inflation; strengthen economic, legal and financial institutions; and establish privatization. The course of economic transition will also be critically determined by political factors in most countries. Whatever the economic policy targets adopted, the major issue is credibility and business confidence. It is these factors which will determine inflows of FDI and encourage domestic private saving and investment, which are key elements for any successful economic transformation and macroeconomic stabilization.

10. FDI is a relatively recent phenomenon in CEE economies. It was only during the 1970s and 1980s that CEE countries began to gradually open up to FDI. Towards the late 1980s, with increased liberalization of foreign-direct-investment policies, inward FDI grew rapidly in terms of number of investments and value of foreign equity participation. However, in terms of overall capital flows, FDI is unlikely to play as large a role in the short to medium term as was widely expected at the start of the reform process. 9/ In some countries, investors remain reluctant to risk substantial equity commitment, given the current uncertainties, while on the domestic side there is reluctance in some countries to sell local assets of a previously public sector activity to foreign interests. 10/ FDI investment in the CEE countries must be analysed from a long-term rather than a short- or medium-term point of view.

11. The CEE countries seek FDI for various country-specific reasons. The promotion of FDI is a strategy component of overall economic restructuring, trade and privatization policies. FDI is expected to contribute to: (i) acquisition of new capital; (ii) acceleration of economic restructuring; (iii) technology transfer; and (iv) diffusion of management and marketing skills. 11/

12. While most companies that invest in CEE are attracted by the potential of both domestic and regional markets, some companies also consider the region as an extension of EC countries and are establishing production facilities there with a view to supplying the entire European market. 12/ In non-sensitive industries, a number of European, United States and Japanese companies have established plants in Central and Eastern Europe to supply both domestic and foreign markets. Although benefits to existing investments may not materialize in the short to medium term, it is the advantages associated with being first in market entry and long-term growth prospects that are leading companies to invest in the CEE.

13. At this stage of the transition process, the major and catalytic benefits of FDI relate to the provision of management expertise, familiarity with export markets, access to advanced technology and the opening up of new sectors of the economy. Macroeconomic stabilization and the creation of an enabling socio-economic environment, including the development of well-structured legal and regulatory frameworks and the institutions required to support and implement them, will be the major determinants of the growth of both foreign and domestic private investment.

14. In spite of the comparatively small size of investment flows, FDI has the potential to make a significant contribution to the economic restructuring process and reintegration of the CEE economies into the world economy through

the diffusion of management and marketing skills, the transfer of product and process technologies and the generation of positive spill-overs by overcoming the informational costs of entering world markets. However, FDI has to be viewed as complementing commercial lending or official flows. 13/

B. Inward foreign direct investment

15. The amounts actually invested in CEE countries remain small by international standards, as is the size of the average investment. In Poland, for example, joint ventures account for less than 5 per cent of exports, less than 3 per cent of sales and less than 2 per cent of employment. Although the size of the average foreign capital per joint venture is somewhat larger in Hungary, the average amount of this capital, mostly from Germany, Austria, the United States and Switzerland, is still generally small, usually less than half of total capital of joint ventures. Investors, in some countries, remain wary of the political and economic risk and the uncertain legal and procedural frameworks.

1. Overall trends 14/

16. There has been a strong growth in FDI flows to CEE countries, most notably to Hungary, former Czechoslovakia and Poland. After starting at a comparatively low level, the growth of FDI appears impressive but is often attributable to individual, large-scale, multi-year projects. 1/

17. Net inflows of FDI into Poland accelerated from $105 million in equity capital in 1990 to $323.5 million in 1991 and an estimated $1 billion in 1992. The FDI inflow into Hungary for 1991 amounted to $680 million by the end of August of that year. Bulgaria reported a sharp increase in net inflows from $4 million in 1990 to $24 million during the first six months of 1992. FDI inflows into Romania accelerated to an estimated $270 million in 1992, compared with $156.3 million in 1991.

18. Between 1991 and 1992, the number of foreign investment projects registered in Romania increased from 1,589 to 20,749. In Poland, there were 4,900 registered foreign investment projects in 1991 and an estimated 9,000 in 1992. It should be noted, however, that in many countries only a fraction of the registered investment projects are operational. In addition, the countries at a more advanced stage of transformation, notably Hungary, former Czechoslovakia and Poland, have attracted the bulk of FDI in the region. Albania, Bulgaria and Romania continue to lag behind in terms of total value of FDI.

19. In Hungary, the number of registered joint ventures and wholly foreign-owned subsidiaries grew from 5,100 at the end of 1990 to an estimated 13,100 by 1 August 1992. Invested foreign capital amounted to $4.85 billion in October 1992. Approximately one quarter of all new business ventures established during 1990 had foreign participation. This share, however, gradually diminished, reaching one fifth in 1992. Accumulated foreign investments, at the end of 1992, represented approximately 8 per cent of the fixed capital of the Hungarian company sector. Even under conditions of

considerable economic and political uncertainty, Hungary attracted important amounts of foreign capital.

20. FDI has also significantly increased in Poland. Only 13 projects were authorized in 1987 and 40 in 1988, but by 15 June 1991 some 4,350 foreign investment projects had been authorized; by the end of 1992 an estimated 9,000 joint ventures had commenced operations and this number is estimated to be on the order of 5,000 by the end of 1992. The estimated value of investment commitments was $3.26 billion by the end of 1992.

21. In Romania, the first half of 1992 witnessed the appearance of significant structural change in FDI. FDI moved from predominantly small-scale investments in such areas as retail trade to medium and large-scale FDI in the productive sectors of the economy and came from such companies as Shell, Amoco Petroleum, Enterprise Oil, Siemens, Alcatel CIT, Asea Brown Boveri and Coca-Cola.

22. In Bulgaria, an estimated 800 joint ventures were registered with cumulative investments of $300 million by 1 October 1991. However, net inflows of FDI remained about 10 times less than in Hungary. In Albania, an estimated 86 joint ventures, with a foreign equity participation of some $10 million, were registered as of 1 November 1992. In former Czechoslovakia, compared to some 204 joint ventures registered in 1989 and 740 registered joint ventures in 1991, an estimated 1,900 joint ventures were registered by December 1992.

23. In the former USSR, emerging States have created a variety of vehicles for foreign investors. However, as in the other CEE economies, joint ventures continue to be the most popular form of investment. Joint ventures became legal only in January 1987; by 1 January 1992, some 5,000 joint ventures had been registered by Goskomastat. The Russian Federation hosted the most joint ventures through October 1991. Subsequently, during the period from March to November 1992, 3,559 joint ventures, with equity capital on the order of $174 million, were registered, as well as an additional 704 companies that are wholly foreign owned, with a total capital committed of R 2,436 million. Central Asia has been the least popular region, although the number of joint ventures in Uzbekistan grew rapidly during 1991 and Chevron and Elf-Aquitaine announced major petroleum projects in Kazakhstan during 1992. Figures for Latvia and Estonia, as of 1 July 1991, indicate that they have outpaced all the former Soviet Republics with the exception of the Russian Federation and Ukraine. A 1992 World Bank report estimates that total foreign investment in the former USSR was on the order of $1.5 billion; 15/ on the basis of actually operating joint ventures, it is estimated that gross foreign direct investment in the Russian Federation totalled $1.2 billion by the second quarter of 1992.

2. Countries of origin

24. European investors, in general, are the most active joint venture partners in CEE economies. According to 1991 Economic Commission for Europe data, European investors, in value terms, are most significant in Albania (90 per cent) and Poland (80 per cent). The corresponding shares are 68 per cent in the former USSR, and 55 per cent in former Czechoslovakia.

25. This situation, however, is changing rapidly. It can be expected that FDI inflows will continue to originate primarily from the economies of the Triad, that is, Western Europe, the United States and Japan, but in the former USSR, in addition to the Triad, Turkey and the Republic of Korea are also active investors and approximately 20 per cent of the value of FDI in the former USSR emanates from developing or CEE countries.

3. Sectoral distribution 16/

26. FDI in the former USSR, Hungary and former Czechoslovakia is concentrated in the manufacturing sector in terms of capitalization of joint ventures. The sector's share by numbers is less pronounced. In other sectors, particularly in business services, such as management of real estate, rental and leasing of machinery and computer-related services, investments are smaller per venture; however, they are higher when measured in number of investments.

27. Trade operations, including foreign trade, account for 20 per cent of all foreign investment projects in former Czechoslovakia and Poland and for 22 per cent in Hungary. In addition, 90 per cent of joint ventures and wholly foreign-owned subsidiaries in Romania indicate trade as one of their activities. In the former USSR, investment in trade activities has remained insignificant until recently, because of restrictions imposed on such ventures.

28. Other sectors of the economy attract comparatively few investments. Construction accounts for about 5 per cent of joint ventures in the former USSR and former Czechoslovakia and about 6 per cent of joint ventures in Hungary. FDI in agriculture, forestry, fishing and mining has remained insignificant. The highest shares in agriculture have been reached in former Czechoslovakia and Poland. Hotels and restaurants are an important sector for FDI in the former USSR.

4. Geographical location 17/

29. FDI typically remains concentrated in the capital regions of CEE countries. Some 55 per cent of joint ventures in former Czechoslovakia are located in Prague and Bratislava. In Hungary, the bulk of joint ventures are located in Budapest and the north-western part of the country. In Poland, however, only 25.6 per cent of joint ventures are located in Warsaw. In the former USSR, 48 per cent of all joint ventures registered by 1 January 1991 were located in Moscow. St. Petersburg and its region accounted for 9.5 per cent of all registered joint ventures. In Albania, more than 60 per cent of all joint ventures are located in Tiranë.

30. This concentration of joint ventures in the capital regions clearly indicates that more advanced infrastructure and access to administrative centres are determinants in locational decision-making. In the case of consumer goods, it is proximity to the relevant markets which is crucial in locational decision-making.

C. Outward foreign direct investment 1/

31. The growth of outward FDI is a further important dimension of the integration of CEE economies into the world economy. By the late 1980s, an initial network of branches, subsidiaries and affiliates had been established. The nature and levels of outward FDI differ considerably among CEE countries. Evidence points to a long-term growth of outward FDI, especially in developed countries, in the form of both new investments and further development of existing investments. The growth of foreign affiliates has led to an expansion of supporting facilities, such as regional offices and retail networks in host countries, as well as the establishment of new branches and subsidiaries. While the immediate problems related to transition in the CEE countries may well result in a temporary deceleration of outward investment activity, in the long run the need for close linkages with Western Europe and integration into the world economy will induce the direct presence abroad of CEE enterprises.

32. Most CEE outward FDI occurred over the past two decades as mounting hard-currency trade deficits and international indebtedness required increasing foreign exchange earnings through export expansion. From 1980 to 1990, total capital committed by CEE companies and joint ventures located in developed market economies amounted to $334 million, raising the total to $1.4 billion committed, with $1.2 billion operational.

33. In contrast to inward FDI, where the foreign share is most often 50 per cent or less, outward FDI tends to be more clearly controlled by home-based investing enterprises. In at least two thirds of the cases recorded at the end of 1990, CEE corporations held 50 per cent or more of the equity in their foreign affiliates. A preference for majority ownership was especially clear in the case of the former USSR. The majority of foreign affiliates are directly involved in the import and distribution of manufactured products in developed market economies. Hence, a majority of CEE investments is concentrated in Western Europe, which constitutes the principal market area for the CEE countries.

34. The sectoral distribution of outward FDI reveals a dominance of tertiary sector operations. While these are predominantly commercial, finance and transport are also important services sector activities for investment. Others include construction and tourism. Primary and secondary activities are typically more important as investment-receiving sectors in the developing countries.

II. POLICY, LEGAL AND INSTITUTIONAL FRAMEWORKS

35. The CEE countries began to pursue policies aimed at establishing links with the world economy only in the late 1960s. Policies included the promotion of "international inter-enterprise cooperation". Some countries also included promotion of joint ventures in approved forms of economic cooperation. Foreign direct investment was increasingly accepted as a means of advancing the "scientific technical revolution" through the acquisition of otherwise unobtainable foreign technology and know-how. The characteristic approach was to allow FDI under rather restrictive conditions with two important limitations: (i) foreign capital participation was allowed only in partnership with a host

country organization and was limited to a minority share (49 per cent maximum); (ii) foreign capital was restricted to selected industries of the host economy (for example, it was excluded from capital goods production and consumer services, as in Hungary in the 1970s, or was limited to small-scale production, as in Poland in the late 1970s and early 1980s).

36. Mounting economic difficulties during the 1980s led to renewed interest in FDI. Economies experiencing large debt accumulation to Western creditors began to view FDI as a source of hard currency and a channel through which to acquire technology, develop human resources and restructure their economies. While the reform and transformation processes initiated in the late 1980s have contributed to removing long-standing institutional barriers to the integration of more substantial amounts of FDI, the rapidly changing and uncertain conditions of transition and reform make it difficult to attract desirable levels of FDI inflows. The following variables and their interaction will be crucial in attracting FDI: (i) legal and regulatory conditions; (ii) economic conditions; (iii) political conditions; and (iv) institutional conditions.

A. The policy framework

37. While CEE countries display marked differences in their initial socio-economic situation and the scope and pace of their institutional reforms and political environment, all of the CEE countries follow broadly similar paths of transformation. In 1991, three basic phenomena could be identified which were common to all of those countries: (i) they were engaged in the process of implementing comprehensive reform-cum-stabilization programmes (although the designs of the programmes and the degree of implementation differed considerably); (ii) they have all been in deep recession; and (iii) the early results of reforms, in most countries, have been less favourable than was initially anticipated.

38. Furthermore, the expected role of foreign capital in the transition process is far from clear. To date, either policy decision-making remains fragmented or important policy issues, regarding, in particular, the degree of government control or management of FDI, the preferential treatment of foreign investors as compared to domestic investors, and the liberalization of capital markets and cross-border capital, have not been explicitly addressed. Moreover, regarding the privatization process, it has not yet been clearly decided whether foreign direct investment should be encouraged by admission to the divestment process. The CEE countries, where they have formulated policies, have taken widely differing approaches to this policy issue. 18/

39. Government official economic policy documents all underline the importance of FDI in economic development. In Hungary, for example, the explicitly stated government target for FDI is to reach a stock of US$ 8-10 billion by the end of 1993, amounting to a 20 to 25 per cent share of foreign ownership of industrial capital. Sectoral development and restructuring policies and strategies, however, do not explicitly incorporate FDI. Given the importance of regional industrial development in the regeneration of economic growth, it is surprising that there is generally no explicit and comprehensive spatial policy or strategy regarding in-country location of FDI.

B. The legal and regulatory framework 1/

40. The rapidly changing circumstances in which policy makers have had to work out new legal frameworks and their relative inexperience in FDI regulations have resulted in ad hoc, piecemeal approaches, in particular in the former USSR. The instability and lack of transparency in legal conditions governing FDI, including the issue of property rights, constitutes in itself a major deterrent to FDI.

41. The most significant developments in establishing legal and regulatory frameworks governing FDI at the domestic level pertain to: (i) entry procedures; (ii) right of establishment; (iii) repatriation of profits and capital investment; (iv) foreign investment taxation and double taxation agreements; (v) ownership of land; (vi) privatization of State-owned enterprises; (vii) currency conversion; (viii) intellectual property rights; and (ix) introduction of international accounting systems. Furthermore, all of the Central European countries, with the exception of Albania, have signed trade and cooperation agreements with the European Community. The Central European countries have also negotiated second generation agreements of association with the European Community. All of the CEE countries now belong to major international economic organizations such as the World Bank, the International Monetary Fund and the General Agreement on Tariffs and Trade, or have indicated a desire to join. These developments were accompanied by various measures to strengthen investment incentives and guarantees, including the negotiation of bilateral investment protection treaties.

42. The majority of CEE countries has a very progressive attitude towards FDI, especially in the area of FDI legislation. Regulations and laws implemented so far all recognize the importance of FDI and the need for basic legal clarity and stability of FDI policy. Much work, however, remains to be done to achieve a broader standard of reliance on laws and the normative functions that they set. There are numerous laws which can affect the behaviour of FDI, ranging from investment protection to intellectual property protection. The present state of FDI legislation is characterized by provision of laws concerning: (i) licensing or the structure by which FDI can participate; (ii) legal protection from expropriation and forms of compensation for expropriation (investment protection); (iii) some form of repatriation of profits if permitted; (iv) certain restrictions of FDI in specialized State-protected industries; (v) import/export legislation, free economic zone development and certain tax incentives as well as joint-venture legislation; and (vi) specific regulations governing the use of hard currency and forms of currency conversion.

43. Under earlier laws governing enterprises with foreign participation, a foreign enterprise was required to obtain authorization from the Government to establish a foreign affiliate. This presented the investor with certain problems relating not to the authorization itself but to the conditions under which it was granted. Applications had to be accompanied by considerable documentation. A feasibility study of the proposed investment project was often mandatory and approval was required from several agencies and ministries. In Albania, Bulgaria, former Czechoslovakia, Hungary and Poland, the need for government approval has now been either partially or totally removed. In those countries in which permission is still required, approval procedures have been shortened and simplified. In Romania, for example, only one agency, the Romanian Development Agency, is responsible for issuing consent and applications are required to be processed

within 30 days. In some countries, however, the legislative process regarding approval and registration of FDI remains time-consuming and lacks transparency.

44. Foreign enterprises, under previous legislation, were often excluded from certain industries, such as banking and financial services, and from engaging in foreign trade and fully owning their business. In addition, they were often obliged to invest a minimum sum in the foundation capital of a foreign affiliate. Domestic legislation now provides for national treatment of FDI. In some instances, notably in trade, foreign investors have acquired rights superior to those of domestic enterprises. In other cases, however, legislation continues to exclude foreign investors from particular industries. This is the case in some of the new independent States, for instance, Belarus.

45. Foreign investors in Hungary, Poland, Romania, former Czechoslovakia and to some extent Albania are allowed to repatriate all their profits in convertible currencies, including proceeds from the sale of their original capital investment. Prior to the introduction of internal convertibility, foreign investors were restricted in the amount they could repatriate and were often forced to use a complicated system of barter in order to repatriate profits from their activities. For example, until June 1991, remittances of dividends from investments in Poland were restricted to the surplus of export earnings over imports generated by a foreign affiliate, plus 15 per cent of net profits derived from sales in the domestic markets.

46. Foreign investors pay taxes in the CEE countries but historically rates have been much lower than those paid by domestic firms. The easing of restrictions on profit repatriation in some countries has generally led to a less favourable fiscal treatment for foreign investors. In general, fiscal incentives are now awarded more selectively. This approach, designed to ensure that domestic enterprises are not placed at a competitive disadvantage vis-à-vis their foreign counterparts, may create a degree of confusion for investors about whether they qualify for special treatment. In Hungary, legislation lists in detail the precise industries in which investors qualify for incentives; in Poland, legislation introduced tax incentives for those investors with more than 2 million European currency units (ECUs) capital investment or those who locate their investments in regions of high structural unemployment.

47. The acquisition of land and buildings by foreign physical or legal persons is a sensitive issue in CEE economies. In particular, corporations may wish to acquire land where investments require acquisition of large land surfaces, or they may wish to purchase land for purely commercial reasons. Land also serves as a collateral when raising commercial loan funds. The legal provisions regarding land ownership in some of the CEE countries are complex and remain in transition between the previous system of collective socialist ownership and the new property legislation enacted in response to the needs of a market economy. At present, property laws in some countries of the region either prohibit foreign ownership of land or fail to provide clear title to a property or its unrestricted transfer from one enterprise to another. In addition, arrangements allowing foreign investors to lease land may be of too short a duration. Lithuania, for example, only permits foreign investors to lease property for 25 years. In Poland, land management law sets out provisions for the sale, use and lease or rental of land owned by the State Treasury or communes to foreign subjects upon consent of the Minister of

Internal Affairs, who is required to submit annual reports to Parliament regarding the sale of land to foreigners.

48. Of equal importance for FDI are laws regulating the transfer of ownership of State-owned enterprises and their assets from the State into private hands. Since the early 1990s, ambitious privatization programmes have been pursued in the CEE countries in which FDI is likely to play an important role. All CEE countries have introduced laws to guide the privatization process, including the creation of government agencies to overview the process and facilitate the technical procedures of the transfer. These laws principally allow for the acquisition by foreign investors of majority stakes in former State-owned enterprises, although restrictions can be found in areas considered sensitive by Governments, such as defence and mining. However, CEE countries differ significantly when it comes to implementation. While all CEE countries have enacted privatization laws, only three countries (Hungary, Poland and former Czechoslovakia) have established the legal preconditions for privatization (for example, property, bankruptcy and securities laws) and sufficiently advanced procedures for implementing such schemes. In former Czechoslovakia, Romania and the Commonwealth of Independent States, a large-scale privatization law has been adopted to promote a mass privatization scheme through the implementation of a voucher system. In other countries, privatization has a more gradual character and so-called small privatization efforts, such as restaurants and shops, have been implemented on a large scale.

49. The foreign purchase of corporate equities may replace joint ventures as the principal vehicle for investment in several countries. Some of the legislation on privatization restricts the right of foreign enterprises to acquire State-owned enterprises. In Hungary and former Czechoslovakia, foreign investors are excluded from participating in small privatizations. It would appear that the early experience of the sale of State-owned enterprises in the CEE countries, the so-called spontaneous privatizations, in the course of which some companies were allegedly sold to foreign investors at discount prices, has encouraged all the countries of the region to ensure that sales to foreigners are properly regulated by the State.

50. Government initiatives to promote FDI have not been confined to reform of national legislation. In particular, the CEE countries have concluded numerous bilateral investment protection treaties. Former Czechoslovakia, for example, concluded 13 such treaties between 1989 and 1991 in order to provide investors with a supplementary level of legal protection. International guarantees that protect investors against harmful acts by the State, including expropriations, are particularly important for foreign investors wishing to invest large amounts of capital in the CEE region. Given these countries' political instability, foreign investors often consider the guarantees that the domestic law provides on such matters as insufficient. 19/

C. The institutional framework

51. At present, the remaining institutional and ideological legacies of centrally planned systems constitute major obstacles to FDI. These include the weakness of core market-oriented institutions both inside and outside of Government. 20/ Legal institutions and accounting standards were weak and did

not conform to those generally accepted in market economies and there was no tradition of independent audits. State-owned enterprises were profoundly shaped by central planning and therefore lacked marketing and strategic planning capabilities and effective inventory controls. They had little or no information on the relative profitability of the various products they were required to produce. Most CEE Governments had little expertise in indirect regulatory instruments, such as monetary policy, taxation, competition policies and the supervision of financial institutions. Hence, there is a need in all of the CEE economies to re-establish market-based institutions and build the associated skill base.

52. Governments have essential functions in market economies, including the provision of infrastructure, legal and regulatory frameworks, correction for monopolies, "externalities" such as environmental costs, and the provision of basic social services and a safety net to alleviate hardship through the collection of taxes and other levies. The CEE Governments face daunting institutional challenges as they attempt to redefine and reorient their role to meet the requirements of a market economy. Not only must they either upgrade or establish new administrative structures of governance, but in many cases they need to reduce their overall size, retrain many civil servants and, if possible, maintain or augment a small cadre of well-qualified policy analysts and decision makers. They also face politically sensitive questions concerning decentralization to regional and local levels.

53. Most CEE Governments have either downgraded or abolished their former planning offices, have consolidated single-industry ministries into a smaller ministry of industry and have established privatization agencies. Many Governments are in the process of setting up training programmes for civil servants, often with international assistance. However, it will require considerable time to re-establish market-based institutions and build the associated skill base. Often, there is a need to educate and train thousands of accountants, bank staff, regulators, lawyers, investment bankers, brokers and others with related skills. 21/

54. The institutional framework for FDI varies from country to country. In Poland, the Ministries of Privatization and Finance and the State Foreign Investment Agency are all directly concerned with FDI. Their activities are coordinated at the level of an advisory committee directly under the Council of Ministers. In Albania, the Foreign Investment Agency, under the Ministry of Trade and Foreign Economic Cooperation, is directly concerned with FDI. There is also a Department of Foreign Investment in the Ministry of Finance and Economy, as well as in other sectoral ministries. In Hungary, the main institution directly concerned with FDI is the Foreign Investment and Trade Promotion Agency of the Ministry of International Economic Relations. Decisions concerning the granting of investment support through the Investment Promotion Fund are made at inter-ministerial committee level. A further inter-ministerial committee is responsible for FDI strategy formulation. FDI promotional activities also vary from country to country. They typically involve the conduct of international investors' conferences and the operation of trade representation bureaus.

III. SOME POLICY IMPLICATIONS

A. The potential role of foreign direct investment

55. The lack of accurate data makes it difficult to assess in any degree of detail the quantitative impact of FDI. The most comprehensive FDI data available concern the number of affiliates established. Data on the value of FDI and industrial activity are often fragmentary in nature. Moreover, details on even the largest investments are not made available on a systematic basis. 1/ Also, a considerable number of small-scale joint ventures avoid statistical measurement. Generally, the contribution of FDI in the transition process has been rather marginal in overall economic terms.

56. In some CEE economies, FDI is beginning to play a role but it is difficult to calculate the ratio of FDI flows to gross domestic capital formation. By using International Monetary Fund data, it is estimated that this ratio was 0.5 per cent for the former USSR in 1989 and approximately 8 per cent for Hungary in 1992. The significance of the impact of FDI varies among countries and sectors. Employment in enterprises with foreign capital participation would also appear to generally remain insignificant in terms of its contribution to total employment. The share of enterprises with foreign capital participation in total exports, as well as their share in total imports, is also generally limited. In Hungary, however, enterprises with foreign capital participation contribute 10 per cent to total employment creation and account for 25 per cent of total exports. FDI is also an important factor in industries such as automobiles, paper, printing and publishing, and some food products. In some countries, FDI has begun to play an active role in high technology industries such as information and communications technology.

57. The capital stock of most CEE economies is old and largely obsolete. Energy intensity in production is several times higher than in countries that are members of the Organisation for Economic Cooperation and Development. Production structures are largely biased towards producer goods industries (steel and non-ferrous metallurgy, machinery, oil refining, chemicals) in which many enterprises are internationally uncompetitive and supply is widely inconsistent with the demands of the domestic market.

58. All CEE countries experience a high level of pollution, which compromises public health and imposes considerable economic losses. Much water is unfit for human consumption and large forest areas have been irreversibly damaged. The Government must take the leading role in promoting environmental clean-up by changing economic incentives, imposing regulations and setting clear standards and targets. The amount of capital required for environmental clean-up is far beyond the financial resources likely to be available. 22/ FDI cannot be expected to become the driving force in the transition to environmentally sound growth but it can play a critical role in the transfer of: (i) environmentally sound production technologies; and (ii) environmentally sensitive and sound business management.

59. The scarce management factor might well prove to be the initial most pressing bottleneck factor in the transition of CEE economies to market economies. FDI already plays an important role in the transfer of management

and organizational techniques and skills by providing (i) a model for operations in the host-country and on-the-job training; and (ii) formal management training programmes and international exchange programmes. In some countries, foreign investors have also participated in the establishment of several management schools.

60. The opening up to FDI and international trade creates opportunities not only for accelerating the restructuring process of a widely obsolete capital stock but also accelerates technology transfer. All the CEE economies recognize the need for improving technology transfer through the promotion of FDI. At this stage, there is no readily available comprehensive information or data on the magnitude or sectoral composition of the impact of the activities of transnational corporations on technology transfer, other than in the area of "soft" technology, such as computerization.

61. FDI will have a considerable impact on the opening up of export markets and thus the integration of CEE economies into the global economy through the well-developed information networks on international markets that FDI can access. In 1990, 16 per cent of Hungary's exports originated from joint ventures. In 1992, it is estimated that some 25 per cent of exports originated from joint ventures. Methodological and other problems, however, make it extremely difficult to measure the impact of FDI on individual countries' balance of trade.

B. Foreign direct investment prospects

62. The CEE countries all have the comparative advantage of a highly educated labour force and in some cases are rich in natural resources. At this stage, however, it is not clear to what extent sufficient momentum for both privatization and FDI can be built up. FDI can contribute decisively to economic growth and trade in this critical period of transition for the CEE economies. However, there remains a need to improve conditions for FDI in the CEE economies. Sound macroeconomic policy, appropriate exchange-rate policies, trade policy and capital market liberalization will be factors determining the inflow of FDI. In addition, there is a need to implement mutually reinforcing and comprehensive privatization policy; trade and anti-monopolization or anti-trust policy; and foreign investment policy. Further, important policy issues concerning short-term profit-taking FDI need to be addressed. It may be that, in the initial stages of the opening-up and transformation process, a relatively flexible policy towards such forms of FDI is preferable in order not to discourage long-term, strategic FDI.

63. Furthermore, the promotion of FDI by the CEE economies is taking place at a time when the fundamental determinants of FDI and the structure of international investment flows are subject to significant changes. At the global level, although FDI flows have grown since the beginning of the 1980s, private sector funds available for investment are not expected to expand significantly in the near future. 23/ Favourable FDI regulations *per se* do not induce urgently needed capital flows. Relatively liberal FDI regimes are a necessary but not sufficient condition for FDI. It is the overall political and economic environment, including the nature and level of structural strengths and weaknesses of a host country, which are of greatest importance.

64. In the short term, the locational advantages for FDI in CEE economies remain comparatively limited in view of the global competition for capital inflows. The physical infrastructure of these countries is weak, income levels lead to low domestic demand and, with the exception of Poland, Ukraine and the Russian Federation, national markets are comparatively small.

65. In general, FDI flows to readily accessible infrastructure services as well as preferential treatment. Hence, there is a need for: (i) improving overall infrastructure availability and its quality; (ii) enhancing the involvement of regional and local Governments in the process of attracting foreign investment; and (iii) in some countries, implementing such specific FDI promotion strategies as the setting up of free economic zones.

66. The lack of regional specialization is clearly visible in the CEE region. To promote FDI, it may be advantageous to develop in the long term new approaches to regional integration, free trade and intra-industry trade and in the short term to harmonize privatization, trade and foreign investment policies among CEE countries. Considering the rapidly evolving and changing political, economic and social circumstances in many CEE countries, it is somewhat hazardous to make any projections regarding the prospects for FDI. However, once the most favourable FDI opportunities have been exploited, it might be difficult to sustain high FDI inflows even under optimal circumstances.

C. International cooperation in the promotion of foreign direct investment

67. There is a continued need for international cooperation in assisting Governments in making the transition to a market economy and strengthening their FDI management capacity. It is important to recognize that international, multilateral, regional and governmental financial institutions and other country-sponsored private sector and government programmes have a significant role in supporting FDI. Such organizations promote a degree of financial and political risk-sharing with the prospective investor and thus contribute to creating confidence. These organizations, furthermore, provide excellent terms for financing specific projects and ventures. Some provide political-risk insurance and also lead private-sector investment missions, thus promoting closer cooperation between private investors and the host country. These organizations have generally become a reliable source of information on specific projects and investment climates.

68. Many multilateral and international organizations involved in promoting and supporting transitional economies have representative offices in the host country and take an active role in advising host Governments in the legal and economic reform process. Most important, in order to accommodate financing available from these organizations, both the investor and host country must meet certain criteria and standards. Such organizations thus play a significant role as financial and legal investment catalysts for the private sector. They can act as the facilitator and initiator of interest, a role in FDI promotion that is sometimes overlooked.

69. Recognizing that management and entrepreneurial capacity development, together with the promotion of FDI, will play a key role in the process of

transition from centrally planned to market-oriented economies, the Department of Economic and Social Development of the United Nations Secretariat, through its Transnational Corporations and Management Division, has designed a programme of integrated technical assistance and human resource development aimed at strengthening national capacities for the effective assimilation of FDI. 24/

70. This integrated programme has three major components. The first involves building a managerial infrastructure for local economic activity and future business, including training of staff in Government and the public and private sectors dealing with various issues relating to FDI. Special attention is given to the development of international accounting in these countries. The second component involves entrepreneurial development: the nurturing of local enterprise through business skills development, technical training and ongoing support of new enterprises. The culmination of this process will be the creation of a national coalition of local businessmen, entrepreneurs and government officials to continue and expand the enterprise creation process. The third component involves regulatory and institutional development in the area of FDI, which is important for preparing the local economy to meet the challenges of FDI, because the regulatory framework determines all activities relating to FDI and its role in the economy. These three components are not separate programmes but are an integral part of the aim, design and implementation of each project.

71. Regarding technical cooperation, a Transitional Economies and Free Zones Section was set up in May 1992. Further, the Director of the Transnational Corporations and Management Division is the Chairperson of the Inter-Agency Task Force on New Independent States. Other major activities of the Transnational Corporations and Management Division, to date, relate to the conduct of various meetings with the aim of facilitating joint ventures and FDI; the preparation of various documents and materials; and the provision of advisory services on foreign investment legislation and institutional frameworks and accounting in a market economy, including the establishment of the Task Force on Improvements in Accounting for Joint Ventures and advice provided towards the establishment and implementation of free economic zones. While, at the request of member countries, a comprehensive programme of activities has been identified, programme implementation remains subject to the availability of funding.

IV. CONCLUSIONS

72. The challenge of overall economic transformation and industrial restructuring in the CEE economies remains a complex task. Far-reaching changes are required, including changes in traditional attitudes; extensive policy reform; new legal and regulatory frameworks; sectoral and subsectoral restructuring programmes; comprehensive privatization; company rehabilitation and modernization; and technology and skill upgrading and retraining in various categories of technical, managerial and administrative staff. At this stage of the transition of the newly opened economies, FDI can play an important role as a catalyst in the opening-up process of the CEE economies, 25/ the enhancing of labour productivity and the transfer of management techniques and skills. In the short term, however, the positive contributions of FDI to transformation must be viewed together with continued requirements for commercial lending, official flows and other forms of non-equity investment.

73. Foreign direct investment in the newly opened economies of Central and Eastern Europe remains in the early stages. Incomplete information, unreliability of data, and rapidly changing and evolving political, economic and social contexts make it difficult to assess with accuracy and in any degree of detail the short-term impacts of FDI on the sectoral restructuring of CEE economies. While FDI, in several country cases, remains predominantly service-sector oriented, it may be desirable to encourage FDI to contribute to a much needed restructuring and renewal of the manufacturing basis of CEE economies. Experience gained to date also points to the need for taking a gradual approach to the promotion of FDI, with careful time-phasing of well-specified and coherent policies and strategies for FDI promotion.

74. Most Governments have made considerable progress regarding the design and implementation of more enabling environments for FDI, including the identification of legal and regulatory frameworks. There remains a need, however, for enhanced transparency regarding policy and other provisions governing FDI, including simplification of institutional arrangements and processes. Again, experience gained points to the need for clear, coherent and transparent regulations regarding expatriation of profits; State guarantees against expropriation; agreements aimed at avoiding double taxation; tax and other incentives; and well-specified technology-transfer and environmental protection policies and strategies. Such comprehensive policy formulation and implementation capacities require continued strengthening. As FDI takes place within the overall macroeconomic and social context prevailing in host countries, macroeconomic and overall stability and predictability will be the main determinants regarding future FDI flows.

75. The newly opened economies of Central and Eastern Europe provide substantial opportunities for FDI development. These include large domestic markets, sustained strong consumer demand, availability of natural resources, access to a highly educated labour force, comparatively low production costs and access to regional markets such as the European Community.

76. There remains an urgent need, however, for strategic international technical support in assisting the transition economies in their efforts to strengthen FDI policy formulation and management capacity. Detailed country and interregional studies, international expert exchange, round-table meetings and training activities could all assist the CEE economies in promoting FDI and maximizing potential benefits from FDI to facilitate transition. Such assistance could also address: (i) regulatory and institutional development in the area of FDI, including studies assessing the potential for FDI, training workshops, investment promotion activities and the establishment and management of free economic zones; (ii) accounting and reporting developments, including improving the regulatory framework and education and establishing accounting and auditing professions; and (iii) entrepreneurial development, including the nurturing of local enterprises through business skill development and technical training.

77. In particular, technical assistance programmes can focus on the analysis, design and implementation of national transformation and privatization policies; the training of entrepreneurs, financiers and corporate managers; and specific investment promotion activities at the regional or country levels. Technical assistance could also be provided in the drafting of investment legislation; tax

and other fiscal regulations affecting transnational corporations; and natural resource legislation in such areas as forestry, minerals, mining, petroleum and other programmes affecting the environment. Assistance could also be provided regarding the negotiation of joint-venture equity and management contracts, technology transfer contracts, the review and restructuring of ongoing contractual arrangements and enterprise development.

78. Considering the formidable challenge of establishing and maintaining an internationally competitive private sector, which will entail the establishment and management of advanced and sophisticated infrastructure and communication networks, finely attuned investment frameworks and economy-wide technologies, there is an urgent need for technical assistance in institution-building and human resource development. Such technical assistance could include the establishment and strengthening of investment boards and information systems on FDI, the identification of comprehensive and coherent policies and strategies facilitating FDI and the establishment and management of free economic zones.

Notes

1/ World Investment Directory, vol. II, Central and Eastern Europe (United Nations publication, Sales No. E.93.II.A.1).

2/ United Nations publication, forthcoming.

3/ For the purposes of this report, the following are included under CEE countries: Albania, Bulgaria, former Czechoslovakia, Hungary, Poland, Romania and the former USSR (comprising the Baltic republics, the Commonwealth of Independent States and Georgia).

4/ Economic Survey of Europe in 1991-1992 (United Nations publication, Sales No. E.92.II.E.1).

5/ World Economic Survey, 1992 (United Nations publication, Sales No. E.92.II.C.1).

6/ World Investment Report, 1992: Transnational Corporations as Engines of Growth (United Nations publication, Sales No. E.92.II.A.19).

7/ Country information was received from country questionnaires completed by national experts and comments made during the Ad Hoc Expert Group Meeting on the Role of Foreign Direct Investment in the Newly Opened Economies of Central and Eastern Europe, Sofia, Bulgaria, 5-7 January 1993. The meeting was organized by the Transnational Corporations and Management Division, Department of Economic and Social Development of the United Nations Secretariat in collaboration with the Government of Bulgaria.

8/ The Economist, (London), 19 December 1992, pp. 49-50.

9/ See World Bank, The Transformation of Economies in Central and Eastern Europe, Policy and Research Series, No. 17 (Washington, D.C., 1991).

10/ "The potential role of foreigners has been a matter of concern in all the CEE economies. Countries want the benefits of foreign expertise and foreign finance. But they are concerned that, in the absence of domestic sources of finance, foreigners will acquire a large part of industry at fire-sale prices. Accordingly at the same time as countries seek foreign expertise, in the form of technical assistance or management contracts, they make provisions to control the share of foreign ownership. These limits may appear redundant at present where there is no large flow of foreign finance into the formerly socialist economies. However, some limits are justified because large-scale foreign purchases at low prices could discredit the entire privatization process." From S. Fischer, "Privatization in East European transformation", in C. Clague and G. C. Rausser, eds., The Emergence of Market Economies in Eastern Europe (Oxford, Blackwell, 1992), p. 237.

11/ According to information provided by national experts.

12/ The total population of 387 million (1991) in the CEE countries is approximately 46.4 per cent of that of the developed market economies (United States of America, European Community, Japan and other). The former USSR makes up 75 per cent of the total population of the CEE countries. Within the former USSR, the Russian Federation makes up over 51 per cent of the total population of 290 million (1991).

13/ For example, "Gross financial disbursement to CEE countries are expected to total about $14.5 billion per year on average in 1991/92. Most will come from official sources, whose disbursements are expected to total almost $10 billion per year. (World Bank lending is projected at $2.5-3 billion annually, and IMF lending at about $4.5 billion in 1991 and $2 billion in 1992.)" From World Bank, The Transformation of Economies in Central and Eastern Europe, Policy and Research Series, No. 17 (Washington, D.C., 1991), p. 29. Further, it is estimated that "A relatively speedy transition (10-15 years) to West European income levels would require investment levels on the order of $200-400 billion per year ... Such investment levels are clearly impossible from the view of either resource availability or absorptive capacity. The unfolding experience of east Germany, though shaped by distinctive factors, appears to confirm the magnitude of the task ahead." From ibid., p. 66.

14/ The data on FDI and joint ventures contained in this section of the report were provided by national experts.

15/ World Bank, Foreign Direct Investment in the States of the former USSR, Studies of Economies in Transformation, Paper No. 5 (Washington, D.C., 1992), p. 8.

16/ See Statistical Survey of Recent Trends in Foreign Direct Investment in East European Countries ([EIECE]) TRADE R.575).

17/ Ibid., and information from national experts.

18/ See also P. J. J. Welfens, "Foreign investment in the East European transition", in Management International Review, vol. 32, No. 3 (Gabler Verlag, 1992), pp. 199-218.

19/ Among other important measures to attract FDI have been the recently concluded bilateral treaties for the avoidance of double taxation of income and capital of which most CEE countries are signatories. By 1991, Czechoslovakia had concluded 19, Hungary 10 and Bulgaria 8 treaties. Also relevant to the promotion of FDI is the New York Convention of 1958 on the Recognition and Enforcement of Foreign Arbitral Awards. Bulgaria, Belarus, former Czechoslovakia, Hungary, Latvia, Poland, Romania, the Russian Federation and Ukraine are parties to the Convention, which binds countries to recognize arbitration awards made in foreign courts. Bulgaria, former Czechoslovakia, Hungary, Poland, Romania and the Russian Federation are also parties to the Paris Convention for the Protection of Industrial Property of 1883. In addition, on 22 June 1992, Slovenia deposited a declaration of continued application to its territory of the Paris Convention. By July 1992, the World Bank Convention on the Settlement of Investment Disputes between States and Nationals of Other States of 1965 had been ratified by Albania, Belarus, former Czechoslovakia, Estonia, Hungary, Kazakhstan, Lithuania and Romania, and the Russian Federation had applied for membership. In all these cases, the States of the region that have recently assumed responsibility for their own international affairs will have to notify the depositories of the above-mentioned treaties with regard to their position on those treaties in order to avoid doubts as to their commitments. Many countries are also parties to the Multilateral Investment Guarantee Agreement. See World Investment Directory, vol. II ...

20/ "If growth in CEE countries is to be accelerated, one needs to create a more productive institutional environment in which investment is made more profitable, and not simply provide increasing amounts of capital. The rather pessimistic picture presented at the beginning implicitly assumes that it will take a long time to create the institutions and capabilities that are necessary to assimilate large amounts of capital productively. It is that institutional gap, and not a capital gap, that needs to be solved if CEE is to have a chance of taking off." L. Summers, "The Next Decade in Central and Eastern Europe", in C. Clague and G. C. Rausser, eds., op. cit.

21/ See World Bank, World Development Report, 1991 (Oxford and New York, Oxford University Press, 1991), p. 154.

22/ Former economic policies in the CEE countries typically tended to undervalue natural resources and placed little value on environmental safeguards, which contributed to serious environmental degradation. This was particularly the case in regard to the pricing of natural resources in enterprise balance sheets in the former USSR.

23/ See Foreign Direct Investment Flows to Developing Countries: Recent Trends, Major Determinants and Policy Implications (UNIDO/PPD.167).

24/ See also United Nations technical publications in these subject areas.

25/ In this context, the General Assembly, in resolution 47/187 recognized "that the full integration of the economies in transition into the world economy should have a positive impact on world trade, economic growth and development, including that of the developing countries". It further recognized "the need for the international community to support the successful process of bringing about economic reforms and restructuring in the economies in transition with due regard to the developing countries among them, without adversely affecting development assistance to other developing countries".